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USE OF MULTIPLE QUALIFIED PENSION PLANS BY SMALL EMPLOYERS AFTER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

by

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SINCE THE ADOPTION of the Employee Retirement Income Security Act of 1974,[1] many employers have adopted more than one pension or profit sharing plan for a variety of reasons. The rules governing the design and structure of multiple pension plans have remained relatively static since 1974 until the adoption of the Tax Equity and Fiscal Responsibility Act of 1982.[2] This article will explore some of the radical changes made by TEFRA to the design and operation of multiple pension plans, particularly by small employers.

I. PRE-TEFRA DESIGN STRATEGIES

A. *Section 415 Limitations*

Section 415,[3] entitled "Limitations on Benefits and Contributions under Qualified Plans," was added to the Internal Revenue Code by ERISA. The limitations imposed on employer deductions for plan contributions, and the limits imposed by Section 415 on maximum benefits provided by a plan had to be observed in order for the plan to meet the basic qualification rules for pension plans under Section 401. For defined benefit plans,[4] Section 415 limited the annual benefit payable to any plan participant to the lesser of $75,000 or 100% of the participant's average compensation for his three highest consecutive years.[5] As a result of cost of living increases, the $75,000 limit was increased

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[1]Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001 et seq. (1976) (effective Sept. 2, 1974) [hereinafter cited as ERISA.]

[2]Pub. L. No. 97-248, 1982 U.S. Code Cong. & Admin. News (97 Stat.) (to be codified in scattered sections of 26 U.S.C.) (enacted Sept. 3, 1982) [hereinafter cited as TEFRA.]

[3]All references to section numbers which are not otherwise identified are references to sections of the Internal Revenue Code of 1954, as amended. Section 401 contains the basic rules for qualified pension and profit sharing plans, discussed in this article. I.R.C. § 401 (1976).

[4]Defined benefit plans are defined in § 414(j). The definition identifies a defined benefit plan as any plan not included in the definition of a defined contribution plan. Section 414(i) defines the term "defined contribution plan" as a plan which provides for individual accounts for participants, with benefits based solely on the value of amounts allocated to those accounts, "and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participants' account." I.R.C. § 414(i) (1976).

[5]I.R.C. § 415(b)(1) (1976).

annually until 1982 at which time it had reached $136,425.[6] For defined contribution plans (including profit sharing, money purchase, and stock bonus plans), Section 415 imposed limitations on the annual additions[7] that could be allocated to any participant's account under such plans. The limitation in the case of defined contribution plans was the lesser of $25,000 or 25% of the participant's compensation for the year.[8] Again, cost of living increases inflated the $25,000 figure to $45,475 in 1982.[9]

The limitations under Section 415, as applied to either defined benefit or defined contribution plans, require that all defined benefit plans or all defined contribution plans covering any participant and maintained by the same employer (including affiliated employers as defined in Section 414) be aggregated for purposes of applying the limitations.[10] Furthermore, if an employer adopted a combination of plans that included at least one defined benefit plan and one defined contribution plan which covered the same employee, separate rules under Section 415(e) applied. The rule in Section 415(e) became known as the "1.4 rule," and generally allowed an employer to utilize 140% of the combined maximum limitations for defined contribution and defined benefit plans. Thus, an employer could adopt a defined benefit plan providing an employee with 100% of his high three year average compensation at normal retirement and also provide the same employee with a defined contribution plan allocation equal to 40% of the maximum 25% contribution each year (or an annual allocation of 10% of compensation.[11]

B. Section 404 Limitations

The rules on deductible limits in Section 404 have remained essentially unchanged by TEFRA. As indicated above, the rules dealing with the employer's deduction for contributions to pension plans were not explicitly tied to the limitations under Section 415.[12] As a practical matter, of course, in a plan covering the employees of a small employer, the employer would generally not want to design a pension program which would require contributions on behalf of rank and file employees in excess of those contributions required to support a level of benefits that results in maximum contributions for the principal or key employees of the organization.

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[6]Pursuant to I.R.C. § 415(d)(1)(A) (1976).

[7]Annual additions are defined in § 415(c)(2), and include employer contributions, forfeitures, and a portion of nondeductible employee contributions in excess of 6% of compensation. I.R.C. § 415(c)(2) (1976).

[8]I.R.C. § 415(c)(1) (1976).

[9]I.R.C. § 415(d)(1)(B) (1976).

[10]I.R.C. § 415(g) (1976).

[11]This assumes that the percentage limitations are less than the dollar limitations imposed under § 415. At higher salary levels, the same concept applies with respect to the dollar limitations.

[12]Prior to TEFRA, no mention was made of § 415 in Section 404. TEFRA added subsection (j) to § 404 to specifically provide that no deductions shall be allowed for any contributions in excess of the § 415 limitations. TEFRA § 235(f).

The primary deductible limit on contributions to pension plans, other than stock bonus and profit sharing plans, is the amount necessary to satisfy the minimum funding standards imposed under Section 412. For stock bonus and profit sharing plans, deductible contributions are limited to 15% of the annual compensation paid to plan participants.[13] If the full 15% contribution is not made in any year, the excess of the 15% limitation over the actual contribution amount can be carried into a future year, subject to a maximum limitation of 25% of compensation, including all such carryovers.[14]

If an employer adopts both a pension plan subject to the minimum funding standards of Section 412 and a stock bonus or profit sharing plan, the combined limitation on contributions to both plans is the greater of 25% of compensation of plan participants or the amount necessary to satisfy the minimum funding standards under Section 412.[15]

C. Combinations of Pension Plans and Profit Sharing Plans

One of the initial considerations which may be of significant importance to a small employer in first establishing a pension program is the ability to retain some discretion in the amount of contributions to be made each year. For this reason, a profit sharing plan is particularly attractive as the initial plan to be adopted by an employer or as an integral part of a combination of plans. Because of the limitation on deductions to combinations of profit sharing and pension plans, such combinations are effectively limited to situations where the employer does not intend or desire to establish a program providing for contributions in excess of 25% of compensation for any employee.

Without taking into account the impact of integrating a plan with Social Security benefits,[16] a typical design would be for an employer to adopt a 10% money purchase pension plan and a profit sharing plan. Both of these plans are defined contribution plans subject to the Section 415 aggregate limitation on annual allocations of 25% of compensation (or the dollar limitation, if less). The minimum funding standard for the money purchase pension plan would be 10% of compensation, and the employer could contribute up to a maximum of 15% of compensation in the profit sharing plan. Although the employer could not normally take advantage of any carryover contributions for the profit sharing plan, the employer would retain the flexibility of contributing as little as 10% or as much as 25% of compensation into the combined program by adjusting his contribution to the profit sharing plan. This type of program does

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[13]I.R.C. § 404(a)(3)(A) (1976).

[14]*Id.*

[15]The various rules regarding the limitations of deductible amounts paid by employers into qualified plans are set forth in the paragraphs of § 404(a). I.R.C. § 404(a) (1976).

[16]The integration of qualified plans with Social Security benefits can have a significant impact on leveraging plan contributions in favor of highly compensated employees. The design and operation of integrated plans are not discussed in this article, but should be considered by any employer in adopting or redesigning one or more qualified plans. Effective in 1984, the rules for integrating defined contribution plans with Social Security have been amended by the adoption in TEFRA of Section 401(1). TEFRA § 249(a).

not involve the "1.4 rule" under section 415(e) because a defined benefit plan is not involved, and the individual limitation on allocations under Section 415 essentially coincides with the 25% deduction limit under Section 404(a)(7).[17]

A less typical arrangement would be to combine a defined benefit plan with a profit sharing plan. This type of combination under pre-TEFRA law was somewhat more complicated because the "1.4 rule" would apply, and the deduction limits under Section 404 did not coincide with the limitation on contributions and benefits under Section 415. Depending on plan design and actuarial factors, the minimum funding requirements for a defined benefit plan can far exceed 25% of the compensation of covered employees. If contributions of this magnitude are called for in a defined benefit plan, that plan could not be combined with an active profit sharing plan, since Section 404 limits the total employer contribution deduction to the greater of 25% of compensation or the minimum amount necessary to fund the defined benefit plan. However, to the extent that the required minimum funding for a defined benefit plan is less than 25% of the compensation of covered participants, the employer could combine that plan with a profit sharing plan. Such a combination would allow the employer to minimize qualified plan contributions in any year by simply meeting the minimum funding standard for the defined benefit plan, or by maximizing plan contributions by contributing an additional amount to the profit sharing plan, up to the maximum 25% limit for both plans under Section 404.

Because of some of the complexities and costs involved in adopting a defined benefit plan including the need to engage a plan actuary and the imposition of the plan termination insurance program under Title IV or ERISA,[18] the adoption of a relatively modest defined benefit program in combination with a profit sharing plan has been unusual. Furthermore, the use of a target benefit plan rather than a defined plan in combination with a profit sharing plan can yield very similar results in terms of plan design and ultimate retirement benefits without the added complexity of a defined benefit plan.[19]

[17]Because annual additions include forfeitures as well as a portion of employee contributions, it may easily be the case that a maximum deductible contribution (25% of compensation) could result in allocations exceeding the § 415 limitations because of forfeitures in the profit sharing plan or employee contributions. Furthermore, contributions to the profit sharing plan must be made out of current or accumulated profits and must be substantial and recurring in order for the profit sharing plan to remain qualified. Treas. REg. § 1.401-1.

[18]There are two significant groups of plans excluded from the plan termination insurance program established under Title IV of ERISA. ERISA § 4021(b)(9) and (13) (codified as amended at 29 U.S.C. §§ 1321(b)(9), (13) (1976)) excludes plans maintained exclusively for "substantial owners," as defined, and plans maintained by professional service employers which do not have more than 25 active participatns in the plan.

[19]A target benefit plan is a type of defined contribution plan that computes its required contributions on acturarial factors. The contribution formula in the plan defines a targeted benefit at normal retirement date, and uses actuarial factors to determine the amount of contribution needed to fund that benefit over the remaining working career of the participant. This type of plan, unlike a defined benefit plan, does not take into account the investment experience of the plan in determining contributions each year. Thus, the targeted benefit is not guaranteed and is only used as a basis for establishing the current contributions.

D. Combination of Defined Benefit and Money Purchase Pension Plans

An employer who has started out with a profit sharing plan or a profit sharing plan in combination with a money purhcase pension plan may find that the Section 415 limitation on individual allocations of 25% of compensation is not sufficient to meet the tax deferral needs or desires of top management or shareholders. Where contributions in excess of 25% of compensation are desirable, a profit sharing plan can no longer be utilized. As indicated above, the required contributions for a defined benefit plan alone may well exceed 25% of the participants' compensation, especially in cases where the highest paid employees are the nearest to retirement age thus increasing the current cost of providing retirement benefits at a specified retirement age. Because an employer could utilize 140% of the combined maximum individual limitations on contributions and benefits under Section 415, it was theoretically possible to establish a defined benefit plan providing an ultimate benefit of 100% of compensation at normal retirement date and a money purchase plan providing a contribution of 10% of compensation (40% of the maximum 25% under Section 415). Alternatively, the defined benefit plan could be limited to 40% of compensation with a 25% contribution under the money purchase plan.[20] Depending on the age of the key employees involved, plan designers should either "maximize" the defined benefit plan or "maximize" the defined contribution plan in these situations to provide the maximum possible benefit to key employees and to minimize the cost of the plans for rank and file employees. The utilization of various funding techniques in defined benefit plans, as well as the availability of integrating one or more plans with Social Security benefits, resulted in substantially disparate treatment of highly paid employees and rank and file employees in the plans of many small employers.

II. TEFRA LIMITATIONS ON BENEFITS, CONTRIBUTIONS AND USES OF MULTIPLE PLANS

A. Reduced Benefit Levels

Faced with the need to raise revenues and with the fact of disparate treatment of highly compensated employees as compared to rank and file employees in the qualified plans adopted by small employers, Congress enacted significantly reduced limitations in Section 415 for all qualified plans. Through cost of living increases the initial maximum benefit and contribution levels enacted in 1974 had almost doubled. TEFRA reduced the maximum levels in Section 415 to $30,000 for defined contribution plans[21] and $90,000 for defined benefit plans,[22] effective generally for years beginning after 1982. The new limits

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Contributions to such a plan are substantially leveraged in favor of older employees who have fewer years over which to fund the targeted benefit. Contributions are, however, limited by the defined contribution rules in § 415.

[20]Again, these examples ignore the dollar limitations under § 415 which apply in the alternative to the percentage limitations if they are less.

[21]I.R.C. § 415(c)(1)(A) (1976), as amended by TEFRA § 235(a)(1).

[22]I.R.C. § 415(b)(1)(A) (1976), as amended by TEFRA § 235(a)(2).

went into effect immediately, however, for any plans established after July 1, 1982.[23]

In addition to lowering the dollar maximums in Section 415, TEFRA also changed or added other provisions in Section 415 to limit contributions to qualified plans on behalf of highly compensated employees. Among these other changes are required actuarial adjustments where benefits under a defined benefit plan commence prior to age 62[24] and the postponement of cost of living increases until 1986.[25]

Prior to TEFRA a defined benefit plan could provide an annual benefit of $136,425 in 1982, commencing as early as age 55. As a result of the TEFRA changes, the maximum annual benefit payable from a defined benefit plan is $90,000 so long as the benefit begins at age 62 or later. If the benefit begins prior to age 62, the $90,000 limit must be reduced on an actuarial basis to reflect a benefit equal to a $90,000 benefit beginning at age 62.[26] There are two important exceptions to the foregoing rule. First, the actuarially reduced amount will not be less than $75,000 if the benefit begins at or after age 55, and if the benefit begins prior to age 55, the maximum benefit may be the equivalent of a $75,000 annual benefit payable at age 55. Second, if benefits begin after age 65, the $90,000 limitation is actuarially increased.

B. Revised Multiple Plan Rule

TEFRA eliminated the "1.4 rule" and replaced it with a somewhat more complicated rule that continues to allow the 140% combined maximum for plan participants up to a certain compensation level, but imposes a 125% maximum at higher compensation levels.[27] The multiple plan rule is further modified under certain circumstances if the plan is a "top-heavy plan," under rules in Section 416 as described below. Under the new rule, the determination of the defined benefit plan fraction and the defined contribution plan fraction has been altered. The basic rule is that the sum of these two fractions for any year may not exceed 1.0 for any participant. The 125% and 140% amounts referred to above are taken into account in the denominators of the plan fractions.

Under prior law, a permissible combination may have been a defined benefit plan providing for a benefit of 100% of compensation at age 65 and a 10% money purchase pension plan. If the highest paid employee was earning $136,425 or less, this type of program would result in a defined benefit plan fraction,

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[23]The effective dates of the changes in § 415 are set forh in TEFRA § 235(g).

[24]I.R.C. § 415(b)(2) (1976), as amended by TEFRA § 235(e).

[25]I.R.C. § 415(d) (1976), as amended by TEFRA § 235(b)(2).

[26]The actuarial adjustments are found in § 415(b)(2)(E) (as amended by TEFRA § 235(e)(4).) Specific statutory limitations on the use of certain actuarial assumptions were set forth to preclude any significant manipulation of such assumptions.

[27]I.R.C. § 425(e)(1) (1976), as amended by TEFRA § 235(c)(1).

under old law, of 1.0 and a defined contribution plan fraction of .4, resulting in the sum of the fractions not exceeding 1.4, as illustrated below:

	Average Compensation	Numerator Annual Benefit (100% Defined Benefit Plan)	Denominator Maximum §415 Defined Benefit	Defined Benefit Fraction
Employee A	$130,000	130,000	130,000	1.0
Employee B	40,000	40,000	40,000	1.0

	Current Compensation	Numerator 10% Money Purchase Plan Contribution	Denominator Maximum §415 Defined Contribution Allocation	Defined Contribution Fraction
Employee A	130,000	13,000	32,500	.4
Employee B	40,000	4,000	10,000	.4

Under TEFRA, the combined fractions for any employee may not exceed 1.0. The defined benefit fraction, however, is defined as having a numerator equal to the projected annual benefit of the participant under the plan[28] and a denominator equal to the lesser of (1) the product of 1.25 muntiplied by the dollar limitation in effect for the year (initially set at $90,000), or (2) the product of 1.4 multiplied by 100% of the participant's average compensation for his high three years.[29] The defined contribution plan fraction is defined as having a numerator equal to the cumulative annual additions made to the participant's account as of the end of the year and a denominator equal to the sum of the following amounts for all years of service with the employer: (1) the product of 1.25 multiplied by the dollar limitation in effect (presently set at $30,000, with the higher pre-TEFRA limitations applying in earlier years), or (2) the product of 1.4 multiplied by 25% of the participant's compensation for the year.[30] It is important to note that the defined contribution plan fraction is a cumulative computation. That is, both the numerator and the denominator of this fraction take into account all years of service with the employer. TEFRA has further complicated the computation of the defined contribution plan fraction by allowing a transitional fraction to be used for years ending before

[28]The term "projected annual benefit" is defined in Treas. Reg. § 1.415-7(b)(3). Such a benefit is based on the assumption that the participant will continue employment until normal retirement age, that compensation will remain level, and that all other relevant factors used to determine benefits will remain constant for future years.

[29]I.R.C. § 415(e)(2)(B) (1976), as amended by TEFRA § 235(c)(2)(A).

[30]I.R.C. § 415(e)(3)(B) (1976), as amended by TEFRA § 235(c)(2)(B).

January 1, 1983. The transition fraction may be of substantial benefit in particular cases by permitting a larger denominator (thus reducing the value of the defined contribution plan fraction) for years prior to 1983.[31]

In applying the revised rules under TEFRA to the example shown above, the combination of plans violates the rule under TEFRA for Employee A, but not for Employee B:

	Average Compensation	Numerator: Annual Benefit (100% Defined Benefit Plan)	Denominator (lesser of): 1.25 times 90,000	1.4 times 100% of compensation	Defined Benefit Fraction
Employee A	$130,000	90,000	112,500	182,000	.80
Employee B	40,000	40,000	112,500	56,000	.71

	Compensation	Numerator: 10% Money Purchase Plan Contributions	Denominator (lesser of): 1.25 times $30,000	1.4 times 25% of compensation	Defined Contribution Fraction
Employee A	130,000	13,000	37,500	45,500	.35
Employee B	40,000	4,000	37,500	14,000	.29

Under TEFRA, the combined fractions may not exceed 1.0, but here the combined fractions for the higher paid employee equal 1.15. For the employee who is earning $40,000 (or for an employee earning up to $80,357), however, the combination of plans is still viable, as the combined fractions for this employee equal 1.0. In effect, therefore, the $40,000 per year employee may still take advantage of a full 140% of the combined maximums applied to both types of plans, and because this employee was not affected by the dollar limitations either prior to or after TEFRA, the combination of plans illustrated in the example is unaffected for this employee by TEFRA.

[31]The statutory provisions relating to the special transition rule are found in Section 415(e)(6) (as amended by TEFRA § 235(d)). The use of this rule may avoid having to review all participants' compensation records for prior years and will, at its best, allow a participant to take advantage of a 1.4 limitation for prior years when the regular computation of the defined contribution factor may have imposed a 1.25 limitation in one or more prior years.

On the other hand, the combined plans for the employee making $130,000 no longer meets the multiple plan rule under Section 415 even after reducing the projected benefit under the defined benefit plan from 100% of compensation ($130,000) to the $90,000 maximum. In order to meet the multiple plan rule, contributions under one or both of the plans must be reduced further. If the allocation under the money purchase plan is reduced to $7,500, the combined fractions for the $130,000 employee would then be reduced to the maximum allowable 1.0 sum.[32]

Again it should be noted that the determination of the defined contribution plan fraction is not as simple as illustrated above, except where the employee is in his initial year of service with the employer. Otherwise, the computation of the defined contribution plan fraction necessarily takes into account all prior years of service with the employer.

C. Top-Heavy Plans

Another significant change in the rules applying to qualified plans is the addition of Section 416 to the Internal Revenue Code and the additional requirement under Section 401(a)(10) that a plan meet the requirements of Section 416 if the plan is a "top-heavy plan."[33]

The intent of Congress in enacting Section 416[34] was relatively simple. Congress intended to generally eliminate the distinctions in the tax law between the qualified plans that could be adopted by corporate employers and the plans that could be adopted by self-employed individuals and sole proprietorships (the so-called "HR-10" plans or "Keogh" plans). In eliminating these distinctions, however, Congress further determined that some of the special restrictions and rules that applied to "HR-10" plans should be extended to all plans, especially where a significant portion of the benefits or contributions under the plan were for the benefit of "key" employees. Thus, while a self-employed individual or a partnership may adopt, beginning in 1984, a qualified plan that is substantially identical to a corporate qualified plan, the top-heavy rules of Section 416 will apply if more than 60% of the contributions, in a defined contribution plan, or more than 60% of the present value of cumulative accrued benefits in a defined benefit plan are attributable to key employees.[35]

For defined contribution plans, the top-heavy test is based on the actual account balances of participants rather than on the dollar amount of previous

[32]Congress did allow a significant "fresh start" in the continued funding of multiple plans. This transition rule is found in Section 235(g)(3) of TEFRA and provides for a reduction of the numerator of the defined contribution plan fraction so that the sum of the two plan fractions does not exceed 1.0. This transition rule applies only in the case of a plan which has satisfied the requirements of § 415 under old law for the last year prior to the effective date of TEFRA.

[33]I.R.C. § 401(a)(10) (1976) as amended by TEFRA §§ 237(e)(1), 240(b).

[34]TEFRA § 240(a) (to be codified in I.R.C. § 416).

[35]TEFRA § 240(a) (to be codified in I.R.C. § 416(g)).

contributions.[36] Once the "key employees" in a defined contribution plan are properly identified, it should be a relatively simple matter, at the end of any particular year, to determine whether more than 60% of the account balances are attributable to such key employees. However, even where an employer has annually made less than 60% of the contributions on behalf of key employees, the plan could nonetheless become a top-heavy plan as a result of employee turn-overs and plan distributions. For example, where non-key employees turn over and either receive distributions from the plan or forfeit a portion of their account balances, the account balances of key employees remaining in the plan may become a larger and larger portion of total plan assets after a period of years. Certain rollover amounts and accumulated deductible employee contributions will not be counted in determining the account balances under a plan in applying the top-heavy test.[37] However, voluntary nondeductible employee contributions, amounts contributed under a salary reduction agreement, and mandatory employee contributions all will be considered in determining the top-heaviness of a plan.

While the identification of key employees may be relatively simple in the case of most small employers, the definition does raise numerous questions which are not readily answered by the statutory provisions. Key employees are defined as any participant during a current plan year or any of the four preceding plan years who is (1) an officer of the employer, (2) any one of the ten employees owning the largest interests in the employer, (3) a 5% owner of the employer, (4) a 1% owner of the employer having an annual compensation exceeding $150,000.[38] With some modifications, the attribution rules under Section 318 will apply in determining ownership under Section 416. The identification of officers of the employer may raise numerous questions with both large and small employers, especially with regard to an employee whose title as an officer does not carry with it significant executive responsibilities. The statute provides that no more than 50 employees or, if less, no more than the greater of 3 or 10% of all employees will be treated as officers. Thus, if a small employer has only 10 employees, there will be no more than 3 officers who are treated as key employees for purposes of Section 416.

If a plan is identified as a top-heavy plan under Section 416, the statute generally limits the amount of a participant's compensation which may be taken into account to $200,000,[39] provides greater portability of benefits for non-key employees, and makes further limitations in the maximum benefits or contributions that may be provided under multiple plans for key employees.

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[36]TEFRA § 240(a) (to be codified in I.R.C. § 416(g)(1)(A)(ii).

[37]Rollover contributions are disregarded for purposes of determining whether a plan is top-heavy under § 416(g)(4)(A). The basis for excluding accumulated deductible employee contributions is found in a statement contained in the conference committee report. H.R. Rep. No. 760, 97th Cong., 2d Sess. 625, *reprinted in* 1982 U.S. Code Cong. & Ad. News 412, 619.

[38]TEFRA § 240(a) (to be codified in I.R.C. § 416(i)(1).

[39]TEFRA § 240(a) (to be codified in I.R.C. § 416(d)).

For purposes of Section 415, the 1.25 factor used to determine the denominator of the plan fractions for the multiple plan rule is reduced to 1.0 unless the plan provides only 90% or less of its benefits or contributions to key employees.[40] Thus, these "super" top-heavy plans will effectively be limited to only 100% of the combined maximums for defined benefit and defined contribution plans for highly paid employees.

D. Examples

The following examples will illustrate the application of the multiple plan rule under Section 415(e) as amended by TEFRA in four different fact situations. In all cases, a business history going back to 1972 has been assumed. Using prior years of service illustrates the mechanics of computing the defined contribution plan fraction. In the case of a defined benefit plan, the computation of the defined benefit plan fraction is based on the current plan formula projected to normal retirement date. Thus, the history of the defined benefit plan, including any changes in accrual rates, is not important in computing this fraction. In the case of the defined contribution plan fraction, on the other hand, the past history is critical even where a plan was not maintained.

In all cases, an assumption has been made that there are no employee contributions of any kind. The examples focus on a single highly paid employee of a hypothetical employer covered under both a defined benefit plan and a defined contribution plan. In all cases, the defined benefit plan provides the maximum available benefit, and the "super top-heavy rule" limiting employees to 100% of the combined maximum for both types of plans has been ignored. If the super top-heavy rule were to apply, no additional contributions could be made to the defined contribution plan unless and until the benefits for key employees do not exceed 90% of the total benefits under all plans maintained by the employer.

In Example 1, the employer did not maintain any qualified plans until 1978. In 1978, a profit sharing plan was adopted and the maximum 15% contribution was made. In 1979, a money purchase pension plan integrated with social security benefits was added providing benefits of 3% of compensation up to $15,000 and 10% of compensation in excess of $15,000. In 1980, the profit sharing plan was terminated and a defined benefit plan was adopted providing for benefits equal to 70% of average compensation at normal retirement date. Simultaneously, benefits in the money purchase pension plan were reduced to 7% of compensation in excess of $15,000. The computations shown below are necessary to determine the defined contribution plan fraction and the amount available in 1983 as a contribution to the money purchase pension plan.

[40] TEFRA § 240(a) (to be codified in I.R.C. § 416 (h)).

In this case the available contribution to the money purchase pension plan has been reduced from the $11,200 which would be called for under the plan formula to a maximum contribution of $8,744. It should also be noted in this example that if that maximum contribution is made in 1983, together with the reduction in the projected benefit in the defined benefit plan from 70% of compensation to $90,000, a further reduction of the defined contribution plan to $7,500 will be required in 1984 in order to keep the sum of the fractions at or below 1.0.

Example 1

Year	Salary	Defined Contribution Annual Addition	Section 415 Dollar Limit	1.25 x $ Limit	1.4 x 25% Salary	Addition to Denominator
1972	$100,000	$ - 0 -	$25,000	$31,250	$35,000	$31,250
1973	110,000	- 0 -	25,000	31,250	38,500	31,250
1974	95,000	- 0 -	25,000	31,250	33,250	31,250
1975	110,000	- 0 -	25,000	31,250	38,500	31,250
1976	110,000	- 0 -	25,000	31,250	38,500	31,250
1977	120,000	- 0 -	28,175	35,219	42,000	35,219
1978	130,000	19,500	30,050	37,563	45,500	37,563
1979	140,000	32,700	32,700	40,875	49,000	40,875
1980	150,000	9,450	36,875	46,094	52,500	46,094
1981	170,000	10,850	41,500	51,875	59,500	51,875
1982	175,000	11,200	45,475	56,844	61,250	56,844
1983	175,000	—	30,000	37,500	61,250	37,500
		$83,700				$462,220

Maximum available sum	1.00
Defined Benefit Fraction = 90,000/112,500 =	.80
Available for defined contribution	.20
Maximum numerator for defined contribution plan = 462,220 times .20 =	$92,444
Additions to numerator through 1982	−83,700
Maximum addition for 1983	$ 8,744

The facts in Example 2 are identical to those in Example 1 except that in this case the employer has maintained multiple plans since 1972. The same profit sharing and money purchase plans maintained during 1979 in Example 1 were in existence here from 1972 through 1979. Again, a defined benefit plan was adopted in 1980 at which time the profit sharing plan was terminated. In this example, the annual additions made to the defined contribution plans over the years var exceed the annual additions made in Example 1. However, because of the "fresh start" rule in Section 235(g)(3) of TEFRA, a $7,500 contribution is nonetheless available in 1983.

Example 2

Year	Salary	Defined Contribution Annual Addition	Section 415 Dollar Limit	1.25 x $ Limit	1.4 x 25% Salary	Addition to Denominator
1972	$100,000	$23,950	$25,000	$31,250	$35,000	$31,250
1973	110,000	26,450	25,000	31,250	38,500	31,250
1974	95,000	22,700	25,000	31,250	33,250	31,250
1975	110,000	26,450	25,000	31,250	38,500	31,250
1976	110,000	25,000	25,000	31,250	38,500	31,250
1977	120,000	28,175	28,175	35,219	42,000	35,219
1978	130,000	30,050	30,050	37,563	45,500	37,563
1979	140,000	32,700	32,700	40,875	49,000	40,875
1980	150,000	9,450	36,875	46,094	52,500	46,094
1981	170,000	10,850	41,500	51,875	59,500	51,875
1982	175,000	11,200	45,475	56,844	61,250	56,844
1983	175,000	—	30,000	37,500	61,250	37,500
		$246,975				$462,220

Maximum available sum	1.00
Defined Benefit Fraction = 90,000/112,500 =	.80
Available for defined contribution	.20
Maximum numerator for defined contribution plan = 462,220 times .20 =	$ 92,444
Additions to numerator through 1982	246,975
Maximum available for 1983 (without fresh start)	($154,531)

NOTE: Section 235(g)(3) of TEFRA allows the numerator of the defined contribution plan fraction to be reduced so that the sum of the two fractions do not exceed 1.0 as of December 31, 1982. In this case the numerator is reduced from $246,975 to $84,944 (84,944/424,270 = .20). Thus, the allowable annual addition for 1983 is $7,500 (92,444 minus 84,944).

Example 3 illustrates the application of the special transition fraction available for defined contribution plans in Section 415(e)(6). Compensation paid to the employee is not as high as in the first two examples, and no plan was maintained prior to 1977. In 1977, a profit sharing plan was adopted and a 10% contribution was made. In 1978, the profit sharing plan was combined with an integrated money purchase pension plan providing for contributions of 3% of compensation up to $15,000 and 10% of compensation in excess of $15,000. In 1979, the profit sharing plan was terminated and a defined benefit plan was adopted providing a benefit of 89% of average compensation. The money purchase pension plan was also reduced to 7% of compensation in excess of $15,000.

In this case, the election of the special transition fraction allows an additional $1,258 to be contributed to the money purchase pension plan in 1983. Under the example, the available annual addition to the defined contribution plan for 1983 is $8,264. If the special transition fraction was not elected, the annual addition would be limited to $7,006. (This is computed by multiplying the "regular" denominator of $363,782 by 0.2 and subtracting the prior annual additions of $65,750.) In any event, the existing formula in the money purchase pension plan only requires a contribution of $7,700 on behalf of the employee. Thus, the plan could remain unchanged for 1983 or benefits could be slightly increased to take advantage of the somewhat higher Section 415 limit.

Example 3

Year	Salary	Defined Contribution Annual Addition	Section 415 Dollar Limit	1.25 x $ Limit	1.4 x 25% Salary	Addition to Denominator
1972	$ 40,000	$ - 0 -	$25,000	$31,250	$14,000	$14,000
1973	45,000	- 0 -	25,000	31,250	15,750	15,750
1974	55,000	- 0 -	25,000	31,250	19,250	19,250
1975	75,000	- 0 -	25,000	31,250	26,250	26,250
1976	90,000	- 0 -	25,000	31,250	31,500	31,250
1977	105,000	10,500	.28,175	35,219	36,750	35,219
1978	125,000	30,050	30,050	37,563	43,750	37,563
1979	110,000	6,650	32,700	40,875	38,500	38,500
1980	110,000	6,650	36,875	46,094	38,500	38,500
1981	100,000	5,950	41,500	51,875	35,000	35,000
1982	100,000	5,950	45,475	56,844	35,000	35,000
1983	125,000	—	30,000	37,500	43,750	37,500
		$65,750				$363,782

Maximum available sum	1.00
Defined Benefit Fraction = 90,000/112,500 =	.80
Available for defined contribution	.20

Special Transition Fraction

Pre-TEFRA denominator

Transition Fraction numerator = lesser of $51,875 or 1.4 times 25% of 1981 Compensation = $35,000	
Transition Fraction denominator = lesser of $41,500 or 25% of 1981 Compensation = $25,000	
Transition Fraction = 1.4	
Transition Rule denominator = 237,550 times 1.4 =	$332,570
Plus 1983 addition to denominator =	37,500
Transition Rule denominator total	$370,070
Maximum numerator for defined contribution plan = 370,070 times .20 =	$ 74,014
Additions to numerator through 1982	−65,750
Maximum addition for 1983	$ 8,264

Example 4 contains the same salary history as Example 3, but in this case no plans were maintained prior to 1983. Again, the election of the transition fraction affords a somewhat higher limitation for the defined contribution plan. The example illustrates that if the employer were to adopt a maximum defined benefit plan for the employee, the multiple plan rule does not effectively impose any limitation on the adoption of a defined contribution plan in 1983. If, in this case, the employer were to adopt both a maximum defined benefit and a maximum defined contribution plan, the defined contribution plan fraction would quickly increase, and contributions would have to be cut back sustantially in the future in order to continue to meet the multiple plan rule.

Example 4

Year	Salary	Defined Contribution Annual Addition	Section 415 Dollar Limit	1.25 x $ Limit	1.4 x 25% Salary	Addition to Denominator
1972	$ 40,000	$ - 0 -	$25,000	$31,250	$14,000	$14,000
1973	45,000	- 0 -	25,000	31,250	15,750	15,750
1974	55,000	- 0 -	25,000	31,250	19,250	19,250
1975	75,000	- 0 -	25,000	31,250	26,250	26,250
1976	90,000	- 0 -	25,000	31,250	31,500	31,250
1977	105,000	- 0 -	28,175	35,219	36,750	35,219
1978	125,000	- 0 -	30,050	37,563	43,750	37,563
1979	110,000	- 0 -	32,700	40,875	38,500	38,500
1980	110,000	- 0 -	36,875	46,094	38,500	38,500
1981	100,000	- 0 -	41,500	51,875	35,000	35,000
1982	100,000	- 0-	45,475	56,844	35,000	35,000
1983	125,000	—	30,000	37,500	43,750	37,500
						$363,782

Election of Transition Fraction, as in Example 3, produces a defined contribution fraction denominator of $370,070 rather than $363,782.

If the employer adopts a defined benefit plan in 1983 providing the illustrated employee with a projected benefit of $90,000 per year, the limits for the defined contribution plan are as follows:

Maximum available sum	1.00
Defined Benefit Fraction = 90,000/112,500 =	.80
Available for defined contribution	.20

Maximum numerator for defined contribution plan = 370,070 times .20 =	$ 74,014
Additions to numerator through 1982	— 0 —
Maximum addition for 1983	$ 74,014

Limited to lesser of $30,000 or 25% of 1983 compensation.

IV. CONCLUSIONS

As a result of the changes to the Internal Revenue Code included in TEFRA, virtually every qualified plan will have to be reviewed. Even in those multiple plan situations where the highest paid employee is currently earning no more than $80,357 (allowing the plans to effectively use 140% of the combined maximums for defined benefit and defined contribution plans regardless of which plan is maximized), the top-heavy rules must be reviewed carefully. In any event, Section 401(a)(10) will require a qualified plan, unless exempted under regulations, to contain rules which will take effect if the plan becomes top-heavy — even if the plan is not top-heavy when Section 416 goes into effect.

A compilation of salary history and prior plan contributions has become an essential element in the design and continued qualification of pension and profit sharing plans. Greater flexibility in plan design will be available to those employers whose combined plan fractions are below the new limitation in Section 415(e). For employers whose pre-TEFRA plans already exceed the parameters of the new multiple plan rule, the most significant design opportunity is the operation of the "fresh start" rule of Section 235(g)(3) of TEFRA. Employers who are given a fresh start on the computation of their plan fractions under this rule should take this opportunity to revise their plans, particularly as to which plan will be maximized or primary in the post-1982 years.